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International Economic & Energy Weekly

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22 March 1985

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22 March 1985

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International Economic & Energy Weekly [redacted]

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22 March 1985

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Synopsis

1 **Perspective—*LDC Countertrade: An Increasing Constraint on Free Trade*** [redacted] 25X1

The rapid growth of countertrade in recent years raises the question of whether linked transactions—counterpurchase, barter, clearing accounts, and offsets—represent a move away from free trade. [redacted] 25X1

11 **LDC Oil: New Countertrade Currency** [redacted] 25X1

In recent years LDCs have turned increasingly to countertrade in the hopes of boosting sales of nontraditional exports. Crude oil and petroleum products have now joined this list and are being bartered in substantial quantities. [redacted] 25X1

[redacted] 25X6

19 **USSR: Short-Term Outlook for Oil Production** [redacted] 25X1

Production of Soviet crude oil and condensate slipped by 100,000 barrels per day (b/d) in 1984, its first decline since World War II. If larger production shortfalls materialize in 1985, the USSR may be unable to satisfy domestic oil requirements and maintain exports to Eastern Europe without some cutbacks in exports for hard currency. [redacted] 25X1

23 **Key Developing Countries: Trends in Economic Performance** [redacted] 25X1

We estimate that real GDP for 25 key LDCs grew 3.2 percent in 1984 from near stagnation in 1983. [redacted] 25X1

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Perspective

LDC Countertrade: An Increasing Constraint on Free Trade

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The rapid growth of countertrade in recent years raises the question of whether linked transactions—counterpurchase, barter, clearing accounts, and offsets—represent a move away from free trade. Much of this increased trade reciprocity reflects the private sector's efforts to adapt to LDC restrictions on trade, including foreign exchange controls, import limits, and cartel pricing agreements. For their part, Third World governments are also turning to countertrade to finance imports and expand exports in the face of foreign exchange shortages and rising debt service payments. In addition to balancing trade on a transaction-by-transaction basis, this policy aids some governments in discouraging imports, disguising export subsidies or dumping, and covertly discounting prices on certain commodities. 25X1

Historically, these practices have reduced trade and increased inefficiency. In the 1930s rigid bilateral trade agreements in Europe practically brought trade growth to a standstill. Modern clearing account agreements within Eastern Europe have also slowed trade expansion; intra-CEMA trade (excluding the USSR) as a share of world trade shrank by one-third between 1960 and 1980. Certain industries such as petrochemicals, which expanded as a result of industrial compensation agreements or "buy-back" deals in the 1970s, are operating at under 70 percent of capacity. Countertrade adds to distortions by attempting to balance trade commodity by commodity or transaction by transaction. 25X1

Trade practices that undermine the multilateral free trade system may be particularly damaging to LDC trade growth. Under GATT a system of trade rights and preferences was established to put smaller countries on an equal footing with large countries. Increased dependence on bilateral trade arrangements will give smaller LDCs less leverage with industrial countries and large multinationals. 25X1

Even with the rapid growth in recent years, countertrade still makes up a relatively small share of world trade. Surveys indicate that some 60 to 70 LDCs and Communist countries have initiated countertrade arrangements. Even if such deals comprised one-fourth of their total imports, it would equal just 5 percent of total world trade. Moreover, most LDCs turned to countertrade as a temporary measure to bridge liquidity problems or to address trade difficulties in certain sectors. 25X1

On balance, we believe economic recovery in the OECD and renewed growth in world trade will reduce the pressures for linked transactions. The sharp increase in US imports has already given LDC exports a big boost. Nevertheless, countertrade warrants continued monitoring. Further growth of this practice or a shift toward more permanent, comprehensive countertrade regulations could impede or further distort international trade. Policies tying investment to trade through offsets or buy-back arrangements could create greater distortions because of their size and duration. [redacted] 25X1

[redacted] 25X1

Briefs

Energy

OPEC February Oil Production

OPEC crude oil production in February rose to 16.8 million b/d, 1.1 million b/d above January's output and 800,000 b/d above the revised production ceiling agreed upon last October. Unusually severe winter weather in Europe during the first two months of the year and a cutback in Soviet oil deliveries contributed to stronger-than-anticipated sales by OPEC members. Saudi output jumped 500,000 b/d, primarily to replenish crude reserves held outside the kingdom. Heavy demand in February led to sales of an estimated 15 million barrels from the Saudi offshore stockpiles. Nigerian production rose 300,000 b/d following a voluntary slowdown for the January OPEC meeting and a strengthening last month in the European market for lighter crude oils. Iran was able to produce an additional 200,000 b/d in February as problems on its Khark Island to Sirri Island crude oil shuttle were ironed out and as exports from the southern Persian Gulf picked up.

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OPEC: Crude Oil Production *Million b/d*

	1984				1985	
	October Quota	Year Average	Fourth Quarter	December	January	February
Total	**16.00**	**17.7**	**16.6**	**16.6**	**15.7**	**16.8**
Algeria	0.66	0.7	0.7	0.7	0.7	0.7
Ecuador	0.18	0.3	0.3	0.3	0.2	0.2
Gabon	0.14	0.2	0.2	0.2	0.2	0.2
Indonesia	1.19	1.4	1.3	1.3	1.3	1.3
Iran	2.30	2.4	2.1	2.3	2.1	2.3
Iraq	1.20	1.2	1.3	1.3	1.3	1.3
Kuwait	0.90	0.9	0.9	0.9	0.9	0.9
Libya	0.99	1.1	1.0	1.0	1.0	1.0
Neutral Zone	[a]	0.5	0.4	0.4	0.5	0.5
Nigeria	1.30	1.4	1.6	1.7	1.4	1.7
Qatar	0.28	0.4	0.3	0.3	0.3	0.3
Saudi Arabia	4.35	4.4	3.8	3.5	3.3	3.8
United Arab Emirates	0.95	1.2	1.2	1.2	1.1	1.1
Venezuela	1.56	1.7	1.6	1.6	1.6	1.6

[a] Neutral Zone has no production quota; output is divided evenly and added to Saudi and Kuwaiti totals.

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Saudis Cancel Two Refinery Projects

[redacted]

The Saudi Petroleum Ministry has terminated two Aramco refinery projects at Qasim and Ash-Shuqayq, according to US Embassy reporting. The move reflects the severity of Saudi efforts required to cope with lower oil revenues and to meet the King's stated goal of balancing the forthcoming budget and has sent new tremors throughout the already-depressed construction industry. Canceling the refineries—planned for 160,000 and 165,000 barrels per day respectively—will save about $2 billion in construction costs and as much as $2 billion in operating and other expenses in the next five years, [redacted] Moreover, the Ministry refuses to reimburse the Aramco capital fund for the $200 million already spent at Qasim. US and Japanese contractors will be paid an indemnity for their canceled orders. Both refineries were once politically favored projects to spread industrialization outside the major cities. [redacted]

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London To Eliminate State Oil Trading Company

[redacted]

London has unveiled legislation to eliminate the British National Oil Company (BNOC) after concluding that the company can no longer contribute to short-term stability in the world oil market. The plan would end the government's role in setting oil prices—a role the government never acknowledged. A new small agency will maintain security of oil supplies—BNOC's primary function—through royalty rights and the option to take oil through participation agreements in an emergency. BNOC formerly took 51 percent of North Sea oil through these agreements. Recent action by BNOC to prevent oil prices from falling has cost BNOC millions of dollars—which the government recoups in part through oil taxes—and has generated fierce criticism of the government's oil pricing policies by a parliamentary committee. Critics of Thatcher's policies also will demand assurances that the new agency guarantee government access to emergency oil supplies. [redacted]

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[redacted]

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International Finance

Moroccan-IMF Accord Pending

[redacted]

Moroccan and IMF negotiators have agreed on the main points of a new standby loan, which is expected to be approved in May. Devaluation of the dirham is the final sticking point, with the Fund pushing for a 10- to 15-percent reduction. The two-year package provides for $85 million in new financing this year with assistance for 1986 to be negotiated in November. Even if food

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subsidies are abolished as planned and foreign debt is rescheduled under similar terms of previous agreements, Morocco still faces a sizable financing gap in 1986. King Hassan will be hard pressed to avoid renewed urban unrest if he goes through with the devaluation, subsidy cuts, and other reductions in government spending. [redacted] 25X1

Tanzanian IMF Negotiations

[redacted]

To end its long-running stalemate with the IMF, Tanzania has offered to increase producer prices by 5 to 10 percent and take additional unspecified reform measures in June as part of its 1985-86 budget. The IMF, however, is seeking an immediate devaluation on the Tanzanian shilling of 50 percent; Dar es Salaam is willing to discuss only 28 percent, spread out over several months. 25X1 President Nyerere, who steps down in October, has been a major obstacle to concluding a standby agreement. [redacted] 25X1

Global and Regional Developments

French Buying Into US Technology

[redacted]

In a shift away from Mitterrand's policy of self-reliance, French electronics firms are securing equity participation in US high-technology firms. CGE and its subsidiary, CIT-Alcatel, have formed a $160 million venture capital partnership with a US firm to invest in small, high-tech US firms. CGE, in a similar move, recently formed a joint venture with Fairchild Industries to develop space communications equipment. In addition, Rhone-Poulenc, also a 25X1 nationalized company, has acquired controlling interest in a US software firm and has formed a joint venture with a US firm to produce silicon ingots and wafers. Despite massive amounts of public funding, the French electronics sector continues to lag the United States and Japan [redacted] 25X1

EC Position on Trade Talks

[redacted]

The EC Council on Tuesday endorsed Community participation in a new round of GATT multilateral trade negotiations but refused to commit the EC to the timing of the talks. The Ten said EC support for launching the new round is contingent on the participation of the developing countries and a firmer consensus on the agenda, and that it would not be explicitly linked to progress on international monetary reform. The Council signaled EC willingness to discuss trade in services and counterfeit goods, but its declaration 25X1 contained no reference to high-technology trade. The Ten also declared the fundamentals of the EC's Common Agricultural Policy off limits. EC policy remains at odds with stated US intentions regarding the schedule and focus of the new round. France has been the main advocate of the trade-money link, but Paris may have softened its position in turn for the more cautious EC approach to the timing and focus of the trade talks. [redacted] 25X1

EC Eases Demands for Curbs on US Corn Gluten Exports

An EC Commission official last week said that the Community would not press for import restrictions on US corn gluten feed. The EC has argued that cheap imported feed substitutes aggravate EC dairy overproduction and displace domestic grain. The volume of US corn gluten exports to the EC fell by over 16 percent in 1984, however, largely because of the strength of the dollar and the impact of new EC dairy production quotas. As a result, the Commission has apparently decided to let the issue lay dormant. If US corn gluten exports pick up or EC grain overproduction worsens, the Community probably will renew its demands for import curbs. 25X1 25X1

Renewed Saudi and Kuwaiti Aid to Iraq

Saudi Arabia and Kuwait will continue to provide about $2.4 billion a year in war relief payments to Iraq by producing oil on Iraq's behalf (about 248,000 barrels of oil per day). The new contract is for one year beginning 1 February 1985, with Iraqi repayment deferred until January 1988. Saudi Arabia also exports between 85,000 and 110,000 b/d from its own production on Baghdad's behalf. Kuwait was reluctant initially to renew the agreement of 1983 because of its own increasing financial strains. Since 1981 Saudi Arabia and Kuwait together have given Baghdad at least $17 billion. Iraq probably will be unable to start repayments in 1988. 25X1 25X1

Spanish-EC Negotiations for Membership

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US Embassy reports indicate Spain's chief negotiator supports settling quickly and renegotiating the membership terms once Spain is in the EC. Even if Madrid yields to EC demands, Spain's target entry date of next January will not be guaranteed. To overcome Greece's threat to block enlargement, EC members still have to reach an agreement with Athens on funds for special Mediterranean aid programs. These programs probably will be a major source of contention at the EC Summit at the end of March. 25X1 25X1 25X1

National Developments

Developed Countries

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Japanese GNP Up in Fourth Quarter

[redacted]

Boosted by a surge in foreign demand, Japan's GNP expanded at a 9.6-percent annual rate in the fourth quarter of last year—ensuring that Japan will reach the government's projection of 5.3-percent growth for the fiscal year that ends 31 March. Imports for the quarter declined, and exports jumped at an annual rate of over 20 percent. Private plant and equipment investment, which has been the strongest sector of the domestic economy, was up by over 17 percent at an annual rate. Private consumption increased at only a 1-percent rate. Growth for calendar year 1984 hit 5.8 percent, the best performance since 1973. [redacted] 25X1

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Inflation Undermines Israeli Economic Package

[redacted]

Criticism of the current wage-price agreement is sharpening since the announcement that February's consumer price index increased by 13.5 percent—more than double the rise in January. Double-digit inflation is expected again this month because of recent subsidy cuts. Some of the sniping by labor leaders reflects posturing as union confederation elections approach. The agreement is slated to last at least until June, but continued squabbling could prompt modifications earlier. [redacted] 25X1

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UK 1985/86 Budget

[redacted]

The Thatcher government plans to cut its budget deficit from more than $10 billion in the fiscal year ending 31 March to $7.7 billion next year. Overall reductions in real spending will include a freeze in real defense expenditures and a 6.6-percent cut in capital outlays. The reductions pave the way for tax cuts of $825 million, but less than half of what Chancellor Lawson had promised last fall. Although the new budget reflects Thatcher's goals of keeping inflation down, restoring confidence in the pound, and encouraging a fall in interest rates, it will do little to combat unemployment in the short term. Lawson rejected widespread appeals to increase spending on jobs programs and instead introduced tax reforms to lower the cost of hiring additional low-income employees and promised an expansion of the youth training program if the private sector carries the major burden of the cost. He also held out the hope of future tax reductions by announcing a study on possible reforms to the personal income tax system. [redacted] 25X1

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New Zealand Economic Policy Disputes

[redacted]

Dissension at the first of the Labor Party's regional conferences last weekend underscores the tenuous hold of Prime Minister Lange over economic policy. According to the US Embassy, the meetings were held behind closed doors to avoid publicizing the degree to which Lange's policy reform efforts have angered the party's left wing. Resolutions were passed against Finance Minister Douglas's proposed goods and services tax and his market-oriented government budget. We believe the passage of the resolutions will increasingly strain the deal reportedly struck by Lange with the left at election time last July—conservative economic policy in exchange for antinuclear foreign policy. Lange must now break leftist opposition at the remaining five regional conferences or face a party mandate—similar to the one that convinced him last year to bar nuclear-capable warships from New Zealand ports—to construct "a truly socialist economy." [redacted] 25X1

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Less Developed Countries

Saudi Budget Cuts

Government spending for the fiscal year that begins on 27 March reportedly is to be 30 percent below appropriations in the current budget. Actual spending, however, probably will be cut by less than 30 percent because the Saudis made efforts not to spend all of the funds allocated for the current year. Nevertheless, reductions of this magnitude will be felt by large and politically sensitive segments of the population, who thus far have been shielded from much of the impact of falling oil revenues. The cuts will focus further attention on the government's handling of the economy, already the subject of growing criticism. [redacted] Oil earnings will decline by roughly $6 billion next fiscal year if current oil prices and production levels remain the same. [redacted]

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Effects of Argentine Grain Port Explosion

The apparently accidental explosion last week at Argentina's major grain port of Bahia Blanca has reduced the grain-handling capacity there by 50 to 60 percent, [redacted] Costs from lost grain sales and repairs could reach $100 million. [redacted] The port handles the bulk of Argentine grain exports to the USSR, and traders report that the Soviets may have to increase their purchases from the United States and other grain suppliers. [redacted]

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More Libyan Belt-Tightening

Libya has implemented a broad range of cost-cutting measures to conserve dwindling foreign exchange reserves, currently estimated at $3.1 billion. Development spending is to be slashed by 19 percent, as many as 400 construction projects—but not including the Great Manmade River scheme—have been canceled, and Tripoli may postpone payment on $2.5 billion in commercial arrears. Restrictions on the repatriation of foreign currency and travel outside Libya also have been increased. In addition, more consumer goods are being rationed and the quality of some items, particularly foodstuffs, has declined sharply. Qadhafi may use the financial crunch as a pretext to make good on his threats to substantially reduce the foreign work force or to raise petroleum production above Libya's assigned OPEC quota. [redacted]

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New Indian Central Government Budget

Prime Minister Rajiv Gandhi's new budget for 1985-86 features lower taxes for business and upper-income groups and extends the liberalizaton of controls on private industry. According to press reports, business leaders are enthusiastic about New Delhi's plans to free many large corporations from stringent

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antimonopoly legislation, eliminate licensing requirements for some industries, and allow small businesses to expand without losing their tax exemption. An immediate cut in corporate income taxes will be followed by further reductions over the next two years, although some investment allowances will be phased out. The budget also calls for higher petroleum prices to cover a large increase in import duties on crude oil, and other proposals will increase the cost of key commodities such as cement, trucks, and rail services. The budget leaves a massive deficit that will be financed by borrowing from the central bank, but Finance Ministry officials believe inflation can be controlled. 25X1

Cutbacks in Costa Rican Banana Crop

Standard Fruit Company has announced it will abandon 950 hectares of banana trees and lay off 10 percent of its work force over the next six months to stem losses caused by depressed world prices, high Costa Rican taxes, and low productivity. Standard—whose parent company is facing possible bankruptcy—unsuccessfully sought tax relief and loan guarantees from San Jose in December. The cutbacks come on the heels of an announcement late last year that United Brands—Costa Rica's other principal banana producer—is closing down its Pacific coast production facilities. Unless world prices rebound, Costa Rica's banana export earnings probably will drop from $240 million last year to $200 million or less in 1985, complicating government efforts to reduce arrearages on debt payments. In addition, the government fears that the loss of some combined 3,000 jobs will lead to renewed labor unrest. 25X1 25X1

Tunisian Labor Postpones Strikes

Members of Tunisia's transportation union have agreed to postpone planned strike activity through April to give the financially strapped government time to negotiate new wage agreements. Other unions probably will support the decision in the expectation of higher wages for the first time in two years. Prime Minister Mzali, however, has little room to maneuver under his proposed austerity budget. Failure to make concessions on wages will substantially increase the likelihood of unrest this summer when the government plans another round of food subsidy reductions. 25X1 25X1

Malaysian Central Bank Governor Replaced

Malaysian Central Bank Governor Aziz, who has been at odds with Finance Minister Daim, will resign in June, according to press reports. Aziz has favored conservative monetary policies and tighter bank and securities market regulation, while Daim advocates stimulating the economy through easier credit and less regulation. Late last year Daim, with Prime Minister Mahathir's support, overruled Aziz's policy of limiting lending for purchases on Kuala Lumpur's stock exchange. Aziz's influence in policymaking was further eroded last month when he was replaced by a Finance Ministry official as chairman of the government supervisory agency for Malaysia's securities market. According to press reports, Jaffar Hussein, executive chairman of the country's second-largest commercial bank, will replace Aziz. 25X1 25X1

Prospects for Zambian Copper Producers

Somewhat higher copper demand and the recent devaluation of the kwacha have boosted revenues and profits for Zambian copper producers, following losses over the past year because of depressed copper prices. Copper prices this year are expected to improve slightly from 1984 levels, and Zambia's copper 25X1
exports—which account for 90 percent of foreign currency earnings—probably will improve as well. Gains for producers, however, may be offset by higher wages after the current labor agreement expires this August. 25X1

Communist

China Searching for Technology

Beijing is making a pitch to overseas Chinese in Southeast Asia to act as middlemen in the transfer of modern equipment and technology. Beijing argues that overseas Chinese can bridge the gap between the West and China through the combination of expertise in a particular technology and sensitivity to both cultures. Among the technologies where overseas Chinese middlemen 25X1
can play a role are food processing and electronics for optical fiber production. In the past some overseas Chinese have assisted Beijing in illegal transfer of technology by giving restricted equipment to visiting Chinese delegations and to Chinese students in the United States. 25X1

LDC Oil: New Countertrade Currency [redacted]

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In recent years LDCs have turned increasingly to countertrade in the hopes of boosting sales of nontraditional exports. The debt crisis and slumping demand for primary commodities has led to increasing use of traditional export products such as sugar, tin, coffee, and rubber in these transactions. Crude oil and petroleum products recently joined this list and are being bartered in substantial quantities. [redacted] as much as 10 to 15 percent of OPEC crude oil—1.6-2.5 million barrels per day, or $16-26 billion annually—is sold under countertrade arrangements. The exact magnitude is not known because of a lack of comprehensive and timely data. Despite this, we estimate since 1980 the frequency and value of such oil agreements has risen substantially. [redacted]

Key Participants

Some oil-exporting countries such as Iran, Iraq, and Libya have been pushing noncash sales for several years. The Iran-Iraq war, combined with the falling oil prices, cut oil revenues in these Gulf states and led them to offer oil as payment for imports. Iran has publicly embraced countertrade, and we estimate that these deals will account for over half of its trade this year. Japan, in particular, has come under pressure from Tehran to accept payment in oil rather than in hard currency for its sizable exports to Iran. [redacted] In Libya, falling revenue and runaway spending caused Tripoli to fall behind in payments to foreign firms for construction projects, and the Libyans are now negotiating payment of these debts in oil. [redacted]

The bartering of oil goes against OPEC's policy of cash-only sales, but Saudi Arabia's billion-dollar exchange of oil for 10 Boeing jumbo jets last

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Defining Countertrade

Countertrade describes trade practices where the sale of goods and services is linked, or countered, by a sale of goods and services in the opposite direction. Countertrade can take many forms:

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- ***Barter** involves the direct exchange of goods without the use of any currency. These arrangements occur mainly between governments. Among oil-exporting countries, complicated **swaps** of various types of crude and product between producers have become increasingly common.*

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- *In a **counterpurchase** transaction, the exporter agrees to purchase products back from the importer up to and sometimes even exceeding the amount of the sale. There are two separate but linked transactions, and foreign exchange is normally used.*

- ***Bilateral clearing agreements** between governments minimize payment in convertible currency. Only the imbalance remaining at the end of a specified period need be settled in cash or in other mutually agreed form. Soviet Bloc countries are the most frequent users of this type of arrangement.*

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- ***Buy-back agreements**, sometimes referred to as compensation, occur when an exporter agrees to supply technology or plant equipment to be paid for with products produced from that plant, usually over a period of years. **Offsets** generally involve military or aerospace deals where the seller enters into coproduction, licensing, direct investment, or subcontracting in the purchasing country.* [redacted]

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summer removed the last source of serious objections by OPEC countries. Nigeria, which had long denied any involvement in these agreements despite rumors to the contrary, announced a major barter deal with Brazil last fall involving $500 million in agricultural goods, chemicals, and construction materials, and some $200 million in automobiles. Algeria is also showing increased interest, often making counterpurchase demands in the final stages of contract negotiations, [redacted]

Other oil exporters still shy away from such trade practices. Venezuela and Mexico have discussed oil barter as part of trade agreements within Latin America, but usually prefer to generate hard currency revenues from their oil exports. Although Indonesia has a mandatory countertrade requirement for all public-sector imports, it deliberately omitted crude oil from the list of acceptable Indonesian products in order not to undercut its cash oil sales. Malaysia is also actively encouraging countertrade, but as yet has inked only one deal known to involve oil. [redacted]

Oil importers also initiate countertrade arrangements. Brazil, which had an oil import bill of nearly $7 billion in 1984, is the most active. According to press reporting, Brazil plans to pay for half of its oil imports through such deals. Brasilia has negotiated agreements totaling several billion dollars in recent months with oil exporters, most notably Iraq and Nigeria. Brazilian goods and services being exchanged include motor vehicles and agricultural goods, as well as construction work. Brazil has curtailed its oil imports from Iran, Libya, and the UAE because these countries were not buying enough Brazilian goods, although talks to resume trade with Iran and Libya are under way. [redacted]

Firms in industrial countries have also acquiesced to countertrade demands—or even offered to make special arrangements in advance—in order to win contracts from oil exporters. In order to promote sales of its Mirage fighter planes to the UAE, for example, France has agreed to be paid in part with oil. Together with Italian firms, the French have accepted crude as partial payment for the construction of the $500 million Iraq-Saudi oil pipeline. [redacted]

The Soviet Union has increased the amount of oil it imports as payment for arms under bilateral agreements with Libya and Iraq. We estimate that the Soviets reexport about half of this oil to hard currency countries at spot market prices, and the remainder goes to Eastern Europe and India under separate bilateral payments agreements. Although Moscow probably prefers cash arms sales, bartering oil probably boosts military equipment sales to these cash-strapped countries and also ensures prompt payment. [redacted]

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Factors Behind Oil Barter

Increased use of oil in LDC countertrade reflects various reasons:

- The poorer oil exporters, facing falling revenues and rising debt service, perceive it as a way to conserve scarce foreign exchange by financing imports and promoting exports simultaneously. Even the richer OPEC states hope to use the policies as a brake on deteriorating trade balances. 25X1

- Oil deals on occasion are also used as a political tool. Iran, for example, provides oil to Syria in exchange for its closure of the Iraqi oil pipeline, according to press reports. To aid Iraq, the Saudis produce oil on Iraq's behalf, part of which goes to the Soviet Union to pay for Iraqi imports of Soviet goods.

- A few oil exporters may view longer term countertrade agreements as a way to keep oil earnings up in the face of falling prices. [redacted] 25X1

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Many oil-importing countries, with oil import bills rising in local currency terms because of the strong dollar, may view this trade practice as useful for stabilizing terms of trade—the amount of oil their exports will buy. Western firms regard it as a necessary cost of doing business in oil-exporting countries and as a marketing tool to outbid competition for lucrative contracts. [redacted] 25X1

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Selected Countertrade Deals Since 1980 Involving Crude Oil

Oil Exporter	Trade Partner	Goods Involved	Export Value [a] (*million US $*)	Oil Volume [a] (*million barrels*)
Ecuador	Brazil	Construction	90	3
Iran	Brazil [b]	Food, chemicals	600	22
	Japan [b]	Steel, automobiles	1,500	54
	Turkey	Various goods	1,000	37
	USSR [b]	Construction	600	22
	Taiwan	Agricultural and industrial goods	300	11
	Yugoslavia	Ships	300	11
	Pakistan	Commodities	200	7
	Greece	Food, textiles	200	7
	Italy	Textile machinery	100	4
	West Germany	Steel products	100	4
Iraq	France	Military equipment	800	29
	France, Italy	Oil pipeline construction	500	20
	Brazil	Automobiles	630	22
	Brazil [b]	Agricultural products	200	7
	Brazil	Water pipes	50	2
	USSR	Arms, construction	230	8
	India	Construction	150	5
	Sri Lanka	Tea	60	2
Libya	Italy	Debt repayment	300	11
	Turkey [b]	Debt repayment	300	11
	Brazil [b]	To be negotiated	500	18
	India	Debt repayment	200	7
	USSR	Military equipment	1,000	36
	Greece	Debt repayment	25	1
Nigeria	Brazil	Food, chemicals, autos	700	25
	Brazil	Petroleum products	500	20
Qatar	Japan	Desalination plant	80	3
	South Korea	Desalination plant	45	2
Saudi Arabia	United States, United Kingdom	Aircraft	1,000	35
United Arab Emirates	France	Military aircraft	450	15
Angola	Brazil	Construction	600	22
China	Brazil	Ore, steel, textiles, tools	300	11
Malaysia	Brazil	Iron ore, various goods	30	1

[a] Estimated.
[b] Under negotiation.

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Although cash sales are still preferable to most oil exporters, OPEC pressure to hold the line on prices has made countertrade an attractive mechanism for disguising discounts and boosting sales. It enables the oil exporter to contract to sell the oil at the official price while implicitly offering a discount by agreeing to an inflated price for the exchnaged goods and services. In its trade of oil for Boeing aircraft, the Saudis argued that the oil was priced at the official level, but the press speculates that an implicit discount was involved because the oil was delivered far in advance of the aircraft delivery. Press sources believe the announcement of the Saudi deal and subsequent large oil sales may have disrupted the oil market last fall and added downward pressure on oil prices.

The amount of discounting is difficult to determine because details are seldom made public and stated prices are somewhat arbitrary. The implicit price probably compensates for the difference between official and spot prices and covers costs and risks inherent in these transactions. Although gaining flexibility in pricing, there is no evidence that these deals enable an OPEC member to disguise exports in excess of its quota.

Implications

Countertrade in oil can have advantages to both importers and exporters. It is unlikely, for example, that Brazil could have expanded its sales to Africa and the Middle East as rapidly as it has without these arrangements. For Western firms, oil bartering presents only a minor inconvenience in contrast to deals involving hard-to-sell manufactured goods such as rataan furniture or Romanian toasters. Oil exporters gain flexibility in oil pricing. The Brazil deal with Iraq, for example, provides for the overland transportation through Jordan of crude that had not been exported since Iraqi Gulf shipments were blocked.

The rapid growth of countertrade nevertheless is creating new rigidities. The resulting bilateral arrangements interfere with free, open, multilateral trade. Distortion of trading patterns and reduction of the gains from free trade can result from: (a) obscuring true monetary prices, (b) balancing trade on a country or commodity basis, (c) increasing government involvment in trade, and (d) making willingness to exchange goods a more important criterion than being the lowest cost supplier. 25X1

Despite the superficial appeal of reducing foreign exchange outlays for imports, we believe foregone hard currency earnings from potential exports and the increased transaction costs exceed the savings. These deals can be an expedient and profitable way to keep oil trade flowing but is regarded by most observers as a second-best alternative. 25X1

Outlook

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Oil countertrade is likely to flourish as long as downward pressure remains on oil prices. Lack of foreign exchange to pay for imports along with a need to revive slumping oil exports or circumvent OPEC price agreements will provide continued impetus for oil exporters. Last year's large Saudi-Boeing oil set an example for other oil exporters. Oil importers like Brazil, together with acquiescent Western firms, will encourage this trend. If oil prices should rise, some oil importers would take 25X1 the initiative as they try to finance a growing oil import bill. In response, most oil producers would become more selective and prefer hard currency payments. 25X1

We believe oil-producing countries increasingly will require offsets, coproduction, subcontracting, or investments, in return for major Western contracts. Last year the Saudis set the pace by requiring offset investments from companies bidding for Peace Shield defense contracts. US companies bidding on radar systems, for example, will have to plow back 35 percent of the project's value into setting up local high-tech manufacturing enterprises. There is a chance that this policy will be broadened to include other major government defense procurements. Other countries may also 25X1 begin to require offsets, or insist on East European–style buy-back arrangements where foreign firms investing in local industries agree to be paid with a portion of the output from the plants they build.

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Mexico: Prospects for Drug Control[1] [redacted]

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Mexican drug activity increased markedly last year, due in large part to the country's economic problems and a weakened drug enforcement program. President de la Madrid appears determined to improve Mexico's antidrug campaign and has initiated changes in the organization and strategy of crop control efforts. [redacted] Additional measures—a more comprehensive anticorruption campaign, more extensive spraying of the numerous fields in inaccessible areas, and prosecution of a major drug trafficker—are needed to help stem increased opium and cannabis production. Mexico is highly unlikely, however, to accept a direct US role in eradication and interdiction efforts. [redacted]

Underlying Factors

After stagnating or declining for nearly a decade, opium and cannabis production for export to the United States as heroin and marijuana increased considerably last year. [redacted] Mexico's opium crop may have nearly doubled in 1984. Embassy reporting and other information suggest that cannabis output also has risen markedly. In addition, Mexico's role as a transshipment point for Colombian cocaine and marijuana exports has expanded. [redacted]

Mexico's economic woes together with problems in the antidrug program caused the recent resurgence of drug-crop cultivation. The financial incentives to produce and traffic in narcotics have increased considerably. Farmers, for example, clearly have found lucrative opium and cannabis production difficult to resist when most other sources of earnings have contracted considerably. Substantial peso devaluations over the past few years have also added to the profits to Mexican drug-crop growers and traffickers. [redacted] 25X1

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During the same period when economic forces have spurred drug-crop cultivation, several factors have combined to considerably weaken Mexico's antidrug campaign: 25X6 25X6

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- Government austerity measures have limited the availability of additional resources for crop control. Meanwhile, high inflation has eroded the purchasing power of Mexican drug-control funds that have been available since 1982. State Department officials say that spending for the eradication program has in recent years remained at roughly the same level of about $13-14 million per year [redacted] 25X6 25X1

- Corruption has greatly hindered antidrug operations. Some malfeasance in the control program has existed for years. [redacted] Even when there has been comparatively little wrongdoing, control measures often have been poorly planned and coordinated. 25X1

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- Countermeasures by farmers—such as hiding fields and planting them in less accessible areas—have continued to thwart tactics Mexico had used successfully until recent years, especially in its aerial herbicide spray program.

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[1] This article presents the key judgments of a forthcoming Intelligence Assessment. [redacted]

- Plentiful rain, which has encouraged production in poorly irrigated areas, also has hampered eradication by making flying hazardous. [redacted]

Stemming the Tide

Despite recent setbacks, we believe that eradication is still the most effective way to significantly cut Mexican-produced drugs because of the virtual invulnerability of the smuggling chain once opium and cannabis leave the fields. In our view, the infrastructure by which the crops are moved to facilities for processing into drugs that are then shipped to the US market is so well entrenched that a sustained land, sea, and air dragnet would be needed to seize a fraction of the amount transported each day. [redacted]

[redacted] President de la Madrid is determined to improve the antidrug campaign. [redacted] he has begun to make changes in the organization and strategy of crop control efforts, such as ordering joint civilian and military sweep operations aimed at destroying drug crops in key zones where traffickers have thwarted routine controls. De la Madrid also is cracking down on drug graft, which press reports indicate has begun to worry him greatly. [redacted]

Additional Measures Required

We believe these strengthened measures, if continued, probably will go a long way toward preventing further big increases in drug-crop production and gradually help bring about some reductions. At the same time, it will not be enough for the Mexicans simply to restore the control program as currently organized to its previous level of efficiency, which enabled them between 1979 and 1983 to eradicate perhaps as much as 70 percent of the potential opium crop and a smaller but substantial portion of potential cannabis output. To keep pace with increased cultivation resulting from economic forces and to compensate for more sophisticated planting techniques and other countermeasures, we believe additional, far-reaching, and—in some instances—politically controversial permanent measures are needed: 25X1

- A reorganization of the aerial spray campaign—concentrating aircraft and other assets in areas of heavy cultivation and facilitating quick reallocation of resources to respond to changes in growing areas—would make it harder for traffickers to keep ahead of the government. Permanently instituting the recently established sweep operations would be a good first step toward achieving such a reorganization.

- A watchdog organization empowered to dismiss summarily drug-control personnel found to be 25X1 colluding with traffickers could speed up efforts to control corruption, which currently is often not 25X1 addressed until it comes to the personal attention of the Attorney General or other senior officials. 25X6 In addition, frequent rotations of police, pilots, and other drug-control personnel would help disrupt any ties that develop between them and local traffickers.

- Helicopters capable of carrying more herbicides and reaching higher altitudes would enable pilots 25X6 to destroy more of the numerous small fields in 25X6 rugged, mountainous elevations.

- The prosecution by the Mexicans of a single 25X1 major trafficker and the substantial disruption of his operations would show that Mexico City is determined to suppress narcotics activity and could broaden public support for antidrug measures. Stepping up recent efforts to educate the Mexican public to the hazards of drug addiction also could help build public backing for strong action against the narcotics trade. [redacted] 25X1

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[redacted]

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USSR: Short-Term Outlook for Oil Production

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Production of Soviet crude oil and condensate slipped by 100,000 barrels per day (b/d) in 1984, its first decline since World War II. This decline reflects the advanced age of almost all of the USSR's largest oilfields and may signal a longer term trend. A decline of about 200,000 to 300,000 b/d in total Soviet production is possible this year with West Siberian production stagnant and output in other regions falling. If larger production shortfalls materialize in 1985, the USSR may be unable to satisfy domestic oil requirements and maintain exports to Eastern Europe without some cutbacks in exports for hard currency. Recent personnel shakeups in the Soviet oil industry reflect leadership concern over the problem.

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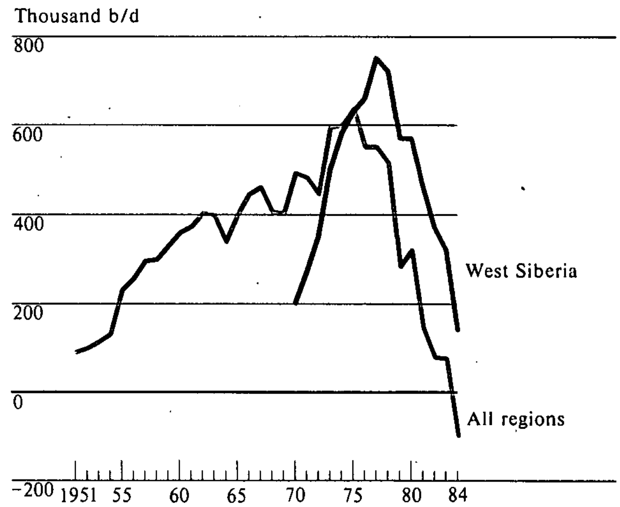
USSR: Year-to-Year Change in Oil Production, 1951-84



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What Went Wrong

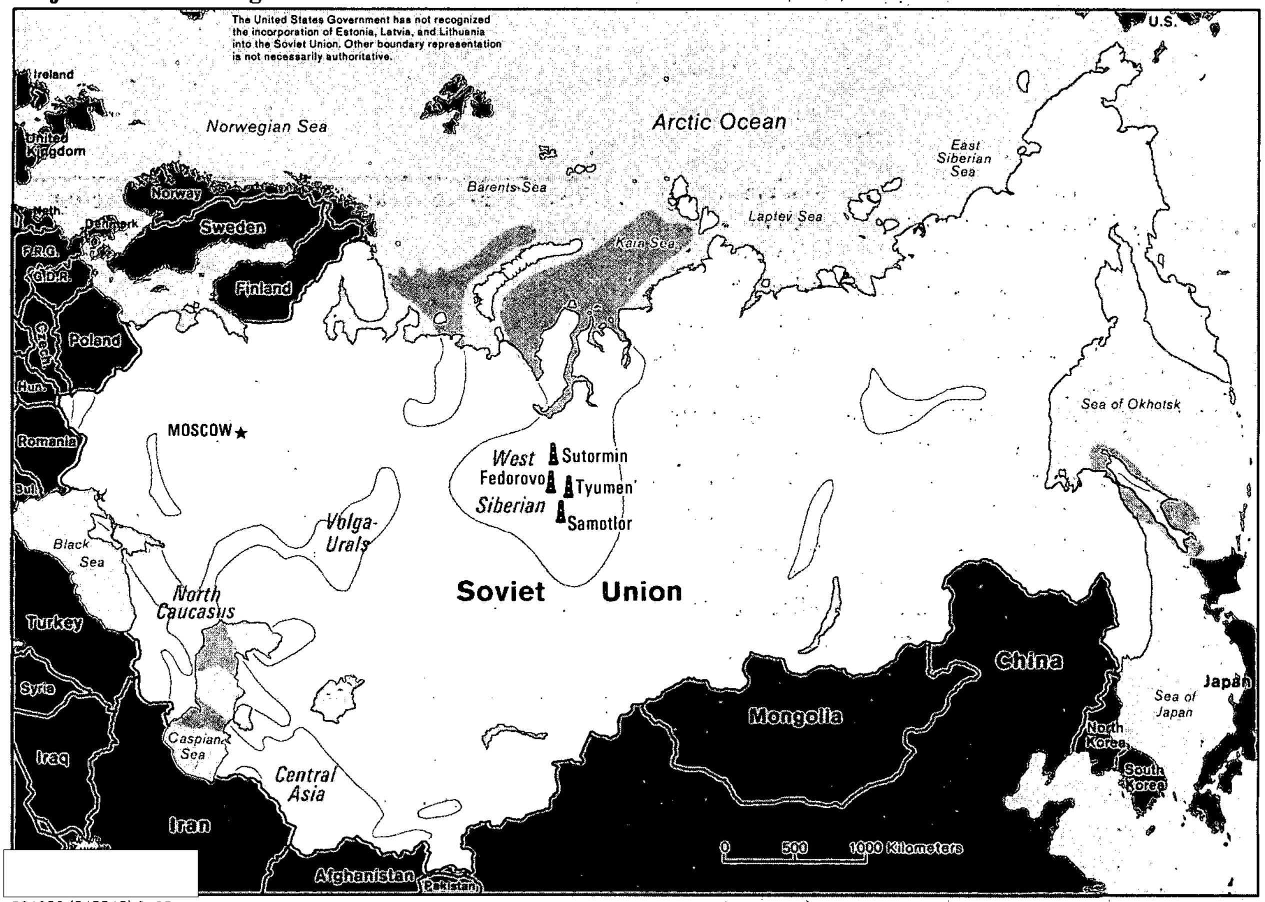
In 1984 total Soviet oil output fell by 100,000 b/d because the growth in West Siberian production was insufficient to offset declines elsewhere. Output in Tyumen'—the major West Siberian oil region—rose only 140,000 b/d rather than the planned 340,000 b/d.

A fundamental factor underlying many of the oil industry's production problems is the increasing age of the USSR's oilfields. The dozen largest fields in West Siberia are now 12 to 15 years old. As the fields age, reservoir pressures decline, reservoir permeability tends to decrease, and water production rises.

Difficulties with water injection systems and sharply rising water content at Samotlor and Fedorovo, two of the largest oilfields in the USSR, are increasing. Severe corrosion problems, for example, now affect Samotlor's pressure-maintenance and oil-gathering systems. Oil flow lines leak, and corrosion has so weakened Samotlor's water-supply lines that full injection pressures cannot be applied. With the average water cut (the percentage of water in the fluid produced from oil wells) estimated to exceed 50 percent, oil production is declining at both fields. These conditions have led to an escalation of well maintenance requirements, which have not been met. 25X1

Moscow is no longer expecting great things from the newly developed area north of Fedorovo. Soviet press articles cite serious production shortfalls and report that some newly drilled wells would not flow. Many wells at the Sutorminsk field have been switched over to pumps far earlier than planned. If new oil deposits to the north of Fedorovo have similar characteristics, production probably will 25X1

Major Oil Producing Areas



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require more wells, equipment, manpower, and time than has been anticipated by Soviet planners. [redacted]

The shortfalls from planned West Siberian production also reflect the lower-than-expected quality of the reserves. Oil industry officials and some Soviet geologists have indicated that the initial Soviet reserve estimates for the Tyumen' oilfields were exaggerated and that estimated recovery rates were too high in view of the less favorable geologic conditions and lower well flow rates being encountered. [redacted]

Production has also been hurt by a shortage of pumps and other oilfield equipment because Soviet planners and managers overestimated the rate at which wells would flow without mechanical assistance. The effect of the planning error was compounded by frequent failures in equipment, electricity supply, and logistic support. [redacted]

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High-Level Concern

The failure to meet oil production goals in Tyumen' Oblast over the past two years caused consternation in Moscow and has brought Tyumen' operations under increasing high-level scrutiny. The continuing dissatisfaction with management of operations

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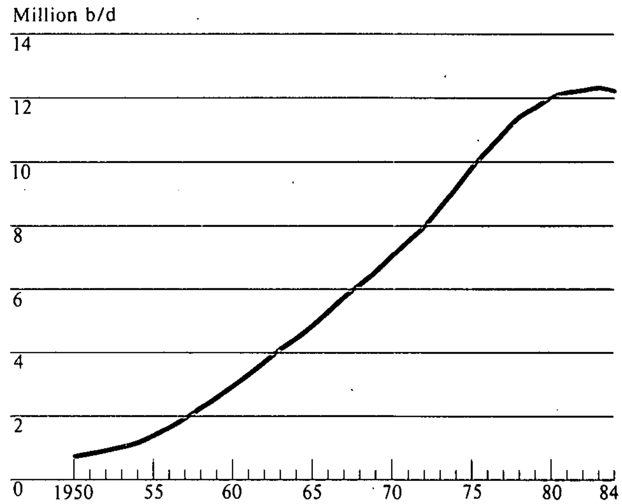
culminated in the firing of almost all of the production managers and the replacement of Oil Minister Mal'tsev. Moreover, several news articles indicate that, in an unprecedented move to improve efficiency, two major organizations that control oil operations in the European USSR have been given responsibility for three West Siberian production directorates.

Outlook

We believe that Soviet oil output in 1985 will be well below the planned 12.56 million b/d and is unlikely to match the 12.23 million b/d posted in 1984. Oil production in January and February—11.92 million b/d—was below plan and 300,000 b/d below the 1984 average daily production level. With oil output from the key West Siberian region showing signs of flattening or possibly declining, total production this year may reach only 11.9-12.0 million b/d.

Efforts to check the decline will be progressively more costly in terms of manpower and investment resources—a factor that affects oil exports decisions. Last year, Moscow was apparently able to sustain exports by increasing reexports of OPEC oil, trimming domestic consumption, and drawing down domestic stocks. With production of 11.9-12.0 million b/d, the USSR, to satisfy domestic oil requirements and maintain exports to Eastern Europe, would have to cut net exports for hard currency. Thus far in 1985, the Soviets have sold little oil on the spot market.

USSR: Oil Production, 1950-84



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Key Developing Countries: Trends in Economic Performance

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We estimate that real GDP for 25 key LDCs grew 3.2 percent in 1984—in large part because of a 15-percent increase in LDC exports to the industrialized countries—from near stagnation in 1983.[1] Following several years of austerity and economic reverses, Brazil and Mexico—the top LDC debtors—appeared to turn the corner in 1984, achieving growth rates of 3 to 4 percent. We estimate that average economic growth in 1985 for the group will remain at roughly last year's pace. Nevertheless, a number of countries are not participating in the recovery—GDP in Argentina, the Philippines, and several major oil-exporting countries is expected to fall this year.

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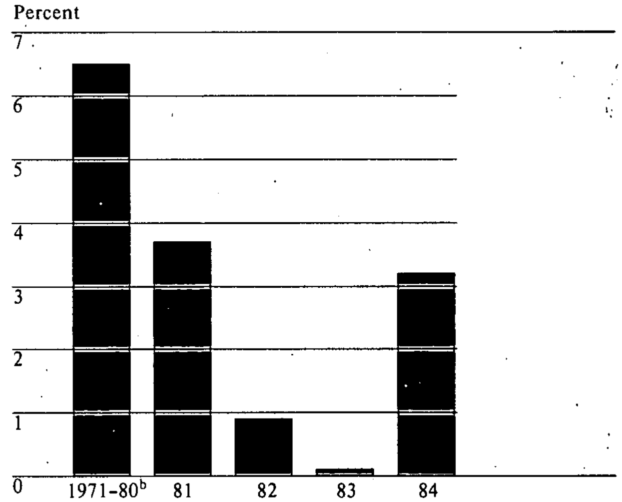
Twenty-Five Key LDCs[a]: GDP Growth



[a] A key LDC is defined to be one with GDP more than $12 billion in 1982.

[b] Average annual.

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Mixed Progress in 1984

Although last year's average economic growth of 3.2 percent in these LDCs was a strong improvement from the near-zero growth in 1983, not all of them shared in the rebound.

Continued Success in Asia. East Asia's GDP growth of 5.7 percent greatly exceeded the performance of other regions. The regional leaders were Taiwan and Hong Kong, two export-oriented economies that responded quickly to the burgeoning demand in industrial countries. Similarly, Malaysia improved its performance in 1984, achieving growth of 6.7 percent. South Korea's expansion last year slackened from the pace of 1983, however, when Seoul tightened monetary and fiscal policies to reduce the current account deficit and slow inflation. The weakest performer in this region was the Philippines where output fell as government spending reductions and import restrictions depressed manufacturing.

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Signs of Recovery in Latin America. Latin American growth of 3 percent in 1984 represented a substantial recovery from the 1981-83 recession when economic activity declined an average 0.7 percent per year. The best performance was turned in by Chile, reflecting increases in manufactured and agricultural exports and additional government

[1] For purposes of this article, we have examined the top 25 economies among non-Communist LDCs. Certain countries that would fall into this group, such as Iran and Iraq, were not considered because current macroeconomic data are not available or are highly suspect. Total and regional growth rates are weighted averages based on relative GDPs.

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Key LDCs: Average Annual Growth of Real GDP [a] *Percent*

	1971-80	1981	1982	1983	1984	1985
Algeria	7.6	4.0	4.1	7.0	5.5	5.0
Argentina	2.2	−6.3	−4.8	3.1	2.0	−2.0
Brazil	8.2	−1.6	0.9	−3.2	4.0	4.5
Chile	1.8	5.7	−14.3	−0.8	4.5	−4.0
Colombia	5.5	2.3	0.9	0.8	3.0	1.0
Ecuador	9.2	3.9	1.8	−3.3	1.5	3.2
Egypt	6.7	6.7	5.5	5.5	4.5	4.5
Hong Kong	7.9	10.4	2.4	5.9	8.5	7.0
India	3.3	5.3	1.8	7.4	4.0	4.0
Indonesia	8.1	7.1	−0.4	5.1	5.0	4.0
Kuwait	1.7	−5.3	−1.4	7.6	2.0	2.0
Malaysia	8.1	7.1	5.6	5.7	6.7	6.5
Mexico	6.9	8.0	−0.6	−5.3	3.5	3.0
Morocco	5.5	−2.2	5.6	0.6	2.0	2.5
Nigeria	3.2	−5.3	−2.2	−4.6	−1.0	−1.0
Pakistan	5.2	6.4	5.6	6.1	3.5	10.0
Peru	3.8	3.0	0.9	−11.9	3.0	2.0
Philippines	6.4	3.4	1.9	1.3	−5.5	−2.0
Saudi Arabia	10.6	7.9	1.7	−10.8	−4.0	−6.0
Singapore	8.8	10.0	6.4	7.9	7.9	7.5
South Korea	8.1	6.9	5.5	9.5	7.5	7.5
Taiwan	8.5	5.0	4.0	7.0	10.0	8.0
Thailand	7.2	6.3	4.1	5.8	6.0	6.0
United Arab Emirates	8.8	9.5	−4.7	−11.0	−2.0	−5.0
Venezuela	4.2	−0.3	0.7	−4.8	−1.7	2.0

[a] The figures in this table through 1983 generally come from the IMF. The 1984 and 1985 figures are based on CIA estimates.

spending. Strong export performances by Brazil and Mexico led to a sharp turnaround from their GDP falloffs in 1983. Argentine GDP in 1984, however, increased at only two-thirds the rate of 1983. In Venezuela, a decline in petroleum output and lower world prices contributed to another year of falling GDP.

Oil Exporters Set Back Again. Most of the other key oil exporters registered low or negative growth in 1984. Kuwait was the only major Gulf oil exporter to see positive growth; even so this performance was only one-fourth the 1983 rate, reflecting the lingering effects of its 1982 stock market crash and stagnant world oil demand. GDP fell in Saudi Arabia for the second consecutive year; in the UAE, for the third consecutive year; and in Nigeria, for the fourth consecutive year. Indonesia proved to be an exception, reflecting additional LNG output and another record rice crop. 25X1

Per Capita Performance. Those countries—mostly in Asia—that were able to make advances in per capita incomes during 1981-83, despite the world economic conditions, had no trouble in maintaining this trend in 1984. Most East Asian countries saw improvements of between 4 and 8 percent, and other key countries including Pakistan and India recorded moderate increases of about 2 percent.

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Despite some slight economic recovery in Latin American and other economies that have been depressed, growth often has not been enough to overcome population increases. In fact, most of the countries where per capita income fell during 1981-83 registered either another decline in 1984 or just small improvements. In the Philippines, Nigeria, and Venezuela, for example, 1984 marked at least the third consecutive year in which per capita GDP declined. Even if growth of per capita incomes reached 2 to 4 percent per year, which was common in the 1970s, per capita income would not return to previous levels for roughly four to five years. 25X1

Outlook 25X1

We estimate that average economic growth for the 25 LDCs we have examined will be 2.9 percent in 1985. Once again, most Asian countries will maintain high growth rates, and the pace of recovery should quicken in Ecuador, Brazil, and Pakistan. Reflecting the slack oil market, however, the major oil exporters, with the exception of Indonesia, are likely to sustain another year of economic decline or at best weak growth. Other countries such as 25X1

Key LDCs: Changes in Per Capita Income in 1981-83 and 1984

	1981-83		1984	
	Increased	Declined	Increased	Declined
Algeria	x		x	
Egypt	x		x	
Hong Kong	x		x	
India	x		x	
Indonesia	x		x	
Malaysia	x		x	
Pakistan	x		x	
Singapore	x		x	
South Korea	x		x	
Taiwan	x		x	
Thailand	x		x	
Argentina		x	x [a]	
Brazil		x	x	
Chile		x	x	
Colombia		x	x [a]	
Mexico		x	x [a]	
Peru		x	x [a]	
Ecuador		x		x
Kuwait		x		x
Morocco		x		x
Nigeria		x		x
Philippines		x		x
Saudi Arabia		x		x
United Arab Emirates		x		x
Venezuela		x		x

[a] 1984 growth near zero; small revisions to our 1984 estimates could move these countries into the lower grouping.

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Colombia and Peru with weak economic expansions but relatively high population increases face further declines in per capita incomes. 25X1

The continued poor economic performance expected in some individual countries could aggravate existing political and social tensions. In Nigeria, another year of economic distress will put additional pressure on the Buhari regime, which already is facing growing discontent. Economic activity in the Philippines will fall again this year and may exacerbate unrest there; falling per capita income this year in Peru and Chile will fuel opposition criticism of government mismanagement of the economy.

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